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POLITICAL ELEMENTS IN THE CREATION OF A MUTUAL FUND INDUSTRY

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INTRODUCTION

Mutual funds have huge financial resources, more than a half-trillion dollars of assets in the aggregate.¹ Only three types of financial institutions (banks, insurance companies, and pension plans) have greater aggregate assets. Yet despite their size, mutual funds rarely participate in corporate governance. They are intermediaries, channeling funds from disparate individuals into investments. They gather and process information about industrial investments that the funds' owners cannot easily gather and process.

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¹ BOARD OF GOVERNORS OF THE FED. RESERVE SYS., FLOW OF FUNDS ACCOUNTS: FINANCIAL ASSETS AND LIABILITIES YEAR-END, 1966-1989, at 30 (Sept. 1990).

They do the paperwork that individuals begrudge. They provide diversification, which is what many investors want. Yet they are not intermediaries that invest in concentrated holdings and that enter the corporate boardroom to represent their shareholder beneficiaries, which is what some investors might want. Voices are heard complaining that institutional investors do not become actively involved in monitoring, or supporting, the managements of their portfolio companies. Yet mutual funds usually stay far from the scene of corporate governance; only rarely can they be found inside the corporate boardroom.

In the 1930s some mutual funds began to act as monitoring intermediaries. They underwrote securities, became active players in bankruptcy reorganizations, and participated in management.² The Revenue Act of 1936, followed up by the Investment Company Act of 1940, forced the funds to stop. Why?

Odder still is the timing of the cut-off of mutual funds from corporate governance. In the early 1930s Berle and Means publicized their finding that with the atomization of shareholdings, power was shifting from shareholders to managers in the large public company.³ Mutual funds could concentrate shareholders' power. The manager of a mutual fund could have been a conduit of shareholder power. The mutual fund would have the potential power and motivation to check the activities of management. But within a few years, tax rules and the 1940 Act raised the cost of (or outright prohibited) close mutual fund involvement with their portfolio companies.

The prohibitions and restrictions were not oversights, nor were their consequences unintended. Key players in the Administration and Congress *wanted* to prevent mutual fund (and other banker) control of industrial companies. Explanations for severance can be seen in (a) popular opinion mistrustful of large financial institutions, (b) public-spirited rules intended to foster stable mutual funds for the average investor, (c) the accidents of tax doctrine, and (d) a glimmer of an interest group story of some political actors favoring local managers over Wall Street.

² See SEC, INVESTMENT TRUSTS AND INVESTMENT COMPANIES pt. 4, at 370-71 (1942) [hereinafter SEC INVESTMENT COMPANY STUDY]; *Investment Dilemma—Trusts Forced to Choose Between Drastic Reorganization and High Tax, Under New Law*, BUS. WK., July 11, 1936, at 45, 46.

³ See A. BERLE & G. MEANS, THE MODERN CORPORATION AND PRIVATE PROPERTY 153-88 (1932).

Opinion polls show the popular mind has mistrusted large financial institutions with accumulated power and has always been wary of Wall Street controlling industrial America. Politicians responded to this mistrust by enacting rules restricting the power of private financial institutions. During the SEC's formative years, its chairman said:

[T]he banker [should and will be] restricted to . . . underwriting or selling. Insofar as management [and] formulation of industrial policies . . . the banker will be superseded. The financial power which he has exercised in the past over such processes will pass into other hands.⁴

A pattern can be seen in the history of American corporate finance.⁵ Institutions that can influence industry are restrained from growing too big. If they do grow anyway, their portfolios are forcibly fragmented. If the fragmented institutions attempt to link themselves together to control industry, law prohibits those links. For banks, insurance companies, pension funds, and mutual funds, the story is the same. Either separately or collectively, they have, perhaps wisely, been stymied from controlling or influencing industry after they have made their investments. What's more, there is a pattern of politics behind these prohibitions. In this article, I examine one of these financial institutions, the mutual fund.

I. THE 1940 ACT RESTRICTIONS

Mutual funds pool the investment funds of hundreds of investors, thereby enabling the investors both to diversify and to buy the investment expertise of the fund's managers. Even when the 1940 Act was passed, cognoscenti recognized that the mutual fund offered a third function, beyond diversification and expert management: "[the investor] may be able to join in the purchase of control of one or more other corporations."⁶ Investment companies could

⁴ W. DOUGLAS, *DEMOCRACY AND FINANCE* 40-41 (1940) (quoting from a speech Douglas gave in 1937 to a stunned audience that included nearly every important Wall Street investment banker).

⁵ See Roe, *A Political Theory of American Corporate Finance*, 91 COLUM. L. REV. 10, 32-36 (1991) [hereinafter Roe, *A Political Theory*]; Roe, *Political and Legal Restraints on Ownership and Control of Public Companies*, 27 J. FIN. ECON. 7 (1990).

⁶ Jaretzki, *The Investment Company Act of 1940*, 26 WASH. U.L.Q. 303, 305 (1941). Jaretzki represented a group of investment companies at congressional hearings on the 1940 Act.

take large blocks of stock, making monitoring worthwhile. In theory they could have evolved into the missing monitoring link between fragmented investors and large operating firms.

A. Power of Control

Congress was suspicious of mutual funds with the power to control industrial companies. A 1934 Senate securities report identified two functions for mutual funds: investment and control of management.⁷ The report asserted the control function was improper for mutual funds. The funds should only passively invest. Holding companies rather than mutual funds were organized for control. And this control was denigrated: the holding company structure was indicted with conflicts of interest that damaged outside shareholders. Holding companies were generally under attack. Public utilities were commonly organized in holding companies until the Public Utility Holding Company Act of 1935 forced their end. That same act directed the SEC to draft legislation dealing with control blocks in mutual funds. And hostility to holding companies can be seen in the 1930's judicial opinions such as *Consolidated Rock* and *Deep Rock*.⁸

Only unscrupulous financiers mixed investment with control: "The investment company [has] bec[o]me the instrumentality of financiers and industrialists to facilitate acquisition of concentrated control of the wealth and industries of the country."⁹ As a consequence, Congress must "prevent the diversion of these [investment] trusts from their normal channels of diversified investment to the *abnormal* avenues of control of industry."¹⁰ Congress might have "to completely divorce investment trusts from investment banking."¹¹ The SEC was later directed to draft legislation.

⁷ See STOCK EXCHANGE PRACTICES: REPORT OF THE COMM. ON BANKING AND CURRENCY, S. REP. NO. 1455, 73d Cong., 2d Sess. 333-34 (1934) [hereinafter PECORA REPORT, in reference to its final chief counsel].

⁸ In *Consolidated Rock Prods. Co. v. DuBois*, 312 U.S. 510 (1941), the Supreme Court refused to respect a holding company, substantively consolidating the assets and liabilities of the parent and subsidiary. In *Taylor v. Standard Gas & Elec. Co. (Deep Rock)*, 306 U.S. 307 (1939), the Supreme Court subordinated the debt due from a subsidiary to its parent company. (To be sure, the misdeeds of the parent company probably justified the results in both instances.)

⁹ PECORA REPORT, *supra* note 7, at 333.

¹⁰ *Id.* at 393 (emphasis added). See also *Investment Trusts and Investment Companies: Hearings on S. 3580 Before a Subcomm. of the Comm. on Banking and Currency*, 76th Cong., 3d Sess., pt. 1, at 36 (1940) [hereinafter 1940 Act Hearings] (quoting the PECORA REPORT, *supra* note 7).

¹¹ *Id.*; cf. A. BERLE & G. MEANS, *supra* note 3, at 183-85 (objecting to unscrupulous

The SEC declared in its proposed bill that "the national public interest . . . [is] adversely affected . . . when investment companies [have] great size . . . [and] have excessive influence on the national economy."¹² In 1935, 65 investment companies had controlling interests in 187 portfolio companies.¹³ Little good could come out of investment company control over portfolio companies, the SEC believed.¹⁴ Big blocks could leave the fund undiversified; due to the lack of diversification the investment company might have heavy losses. The investment company might pump money into the portfolio company to protect a large position, unwisely change the portfolio company's financial policy or capital structure, force dividends out from the portfolio company at too high a rate, or force a merger on terms disadvantageous to the outside shareholders of the controlled company.¹⁵

The SEC conceded that mutual funds had the expertise, motivation and financial muscle to ameliorate the informational and organizational problems of scattered shareholders. "These investment companies can perform the function of sophisticated investors, disassociated from the management of their portfolio companies. They can appraise the activities of the management critically and expertly and in that manner not only serve their own interest but also the interest of the other public stockholders."¹⁶ Nevertheless, the disadvantages of investment companies with the power to control outweighed the advantages. The SEC wanted mutual fund directors and employees off the boards of all portfolio companies; they wanted a Glass-Steagall-type severance.¹⁷ They also wanted to bar any fund from exceeding \$150 million in

holding companies).

¹² *1940 Act Hearings*, *supra* note 10, pt. 2, at 434. This statement of purpose also showed concern for efficient investment management and protection of investors.

¹³ See SEC INVESTMENT COMPANY STUDY, *supra* note 2, at 8; WHARTON SCHOOL OF FINANCE AND COMMERCE, A STUDY PREPARED FOR THE SEC, H.R. REP. NO. 2274, 87th Cong., 2d Sess. 399 (1962) [hereinafter WHARTON INVESTMENT COMPANY STUDY].

¹⁴ See SEC INVESTMENT COMPANY STUDY, *supra* note 2, at 22.

¹⁵ See *id.*; WHARTON INVESTMENT COMPANY STUDY, *supra* note 13, at 400.

¹⁶ SEC INVESTMENT COMPANY STUDY, *supra* note 2, at 371; WHARTON INVESTMENT COMPANY STUDY, *supra* note 13, at 400 n.9.

¹⁷ See *1940 Act Hearings*, *supra* note 10, pt. 1, at 216-20. The Glass-Steagall Act severed most commercial and investment banking functions. In recent years, its scope has been limited and the Administration recently proposed abolishing most of it. See U.S. DEP'T OF TREASURY, MODERNIZING THE FINANCIAL SYSTEM: RECOMMENDATIONS FOR SAFER, MORE COMPETITIVE BANKS (1991), *reprinted in* Fed. Banking L. Rep. (CCH) Report Letter No. 1377, pt. 2, at 53-59 (Feb. 14, 1991).

assets.¹⁸ Eventually the SEC had to compromise with the mutual fund industry, but they still achieved a great deal of severance.

B. *Diversification*

First, under the Investment Company Act of 1940, a mutual fund cannot advertise itself as "diversified" if it owns in the regulated part of its portfolio more than 10% of the voting stock of any company.¹⁹ Three-quarters of the portfolio is subject to this fragmentation rule, *even if* that influential block of stock is only a small portion of the fund's entire portfolio. The SEC wanted that restriction to disable mutual fund control of portfolio companies.²⁰ Some mutual funds might have competed as monitors by owning large blocks of stock. That prospect was cut-off for diversified investment companies. Today, virtually all mutual funds call themselves diversified: they do not control public firms.

Not registering under the 1940 Act won't help the fund to avoid the prohibition on control: any public company holding itself out as investing in securities is an "investment company" under the Act. No unregistered investment company shall "control any company [engaged in] interstate commerce."²¹ (If the company is through *majority-owned subsidiaries primarily* in the business of its subsidiaries, then it can be exempt from the 1940 Act.²²)

Several states have had even more severe restrictions: to sell mutual fund shares to their residents, the fund cannot own more than 10% of any portfolio company.²³ Many mutual funds have adopted an investment policy of not permitting themselves to use even the limited portfolio concentration that the 1940 Act contem-

¹⁸ See *1940 Act Hearings*, *supra* note 10, pt. 1, at 188 (statement of David Schenker, Chief Counsel SEC Investment Trust Study), pt. 2, at 375, 400-01, 412. The SEC also refused requests that it recommend that the IRS allow mutual funds with control blocks to have untaxed, pass-through status.

¹⁹ See Investment Company Act of 1940 (1940 Act) § 5(b)(1), 15 U.S.C. § 80a-5(b)(1) (1988).

²⁰ See *1940 Act Hearings*, *supra* note 10, pt. 1, at 188 (statement of David Schenker); T. FRANKEL, *THE REGULATION OF MONEY MANAGERS*, § 33.1, at 343 (1978).

²¹ 1940 Act §§ 3(a)(1), 7(a)(5), 15 U.S.C. §§ 80a-3(a)(1), 80a-7(a)(5) (1988).

²² See *id.* § 3(b)(1), (c)(6), 15 U.S.C. § 80a-3(b)(1), (c)(6); T. FRANKEL, *supra* note 20, at 378-80.

²³ See WHARTON INVESTMENT COMPANY REPORT, *supra* note 13, at 403 (noting Ohio, California and a few others); OHIO ADMIN. CODE § 1301:6-3-09(G)(1)(h) (1977) (prohibiting management-type investment companies from selling shares in Ohio if any part of the portfolio has more than 10% of the voting stock of a company).

plates. State rules and the tax limitations discussed in the next section help explain why.

The 1940 Act requires that mutual funds calling themselves diversified have no more than 5% of the mutual fund's regulated assets in the securities of any one issuer.²⁴ As a diversification standard, this provision is crude. But in the context of the 1930s understanding of finance it seems superficially defensible. Mutual funds are often designed for unsophisticated investors who cannot assemble a diversified portfolio or evaluate the mutual fund's portfolio.²⁵ By requiring some standard of fragmentation if the fund chooses to call itself *diversified*, the 1940 Act helps make sure investors get what they were promised.

But this crude standard only justifies the 5% restriction (the mutual fund may not invest more than 5% of its regulated assets in any single company). The 10% restriction (the mutual fund may not buy more than 10% of a *portfolio* company's voting stock) is unnecessary for true diversification. Obviously, an investment company could have a small portion of its assets in a single firm, but if the firm were medium-sized the investment company could have an influential block of stock. Thus, the not-so-hidden goal was to disable control, not to promote diversification.

To be sure, the rule has disclosure benefits. And even a modern definition of diversification would require some fragmentation. A modern notion of diversification would not use the 10% restriction, which prohibits purchase of more than 10% of any portfolio company's stock. But the result might be close to the same. Only mutual funds much larger than any that now exist would be able to diversify, and take greater 10%+ blocks of the largest American public companies.

And the 10% restriction might instead be justified as a liquidity rule. Open-ended mutual funds must be prepared to redeem their stock. Heavy redemption would require the fund to sell portfolio stock, and a portfolio full of 10%+ holdings might be illiquid, if only because of 16(b) restrictions.²⁶

²⁴ See 1940 Act § 5(b)(1), 15 U.S.C. § 80a-5(b)(1) (1988).

²⁵ See 86 CONG. REC. app. at 1478 (1940) (remarks of Sen. Wagner); PECORA REPORT, *supra* note 7, at 348-51 (criticizing mutual fund that put 19% of its assets into a railroad's stock).

²⁶ See Securities Exchange Act of 1934 (1934 Act) § 16(b), 15 U.S.C. § 78p(b) (1988). Under Section 16(b) of the 1934 Act, profits from stock bought and sold within six months must be disgorged, irrespective of whether inside information motivated the purchase or sale.

Although the 1940 Act definition prevents a large diversified fund from taking large chunks of portfolio companies' stock, the rule is only a nuisance, not a show-stopper: the fund could decline to call itself diversified and *this* part of 1940 Act wouldn't bite. But as shall be seen, the large block would trigger other 1940 Act nuisances; the 1940 Act, and other rules, make it difficult to network medium-sized blocks held by several different financial institutions, and tax rules that roughly track the diversification definition would *still* apply, and be more than a nuisance.

C. Networks and Affiliates

The 1940 Act exempts a quarter of the portfolio from the fragmentation rules. And, the fund could choose theoretically not to call itself diversified in order to avoid regulation under the fragmentation rules. (I say "theoretically" because, as the next section shows, tax penalty rules track the 1940 Act's diversification rules.)

But for that limited portion of the portfolio that may be concentrated, other restrictions apply. True, the 1940 Act does not explicitly prohibit a mutual fund or its employees from sitting on the board of a portfolio company, as the SEC sought. But if the mutual fund owned 5% of a portfolio company's stock and networked with a group of institutions owning 5% of the stock of the portfolio company, all would become 1940 Act affiliates. The 1940 Act prohibits the mutual fund lacking an SEC exemption from acting jointly with an affiliated financial institution to join a portfolio company's board of directors, or otherwise jointly assert influence.²⁷

Less significantly, if the block of stock were big enough so that the network's representative sat on the portfolio company's board and sufficiently influenced decisions so that it had a "controlling influence" that was attributed to the mutual fund, then transactions between any other member of the network and the portfolio company would be prohibited without SEC exemption.²⁸

²⁷ See 1940 Act § 17(d), 15 U.S.C. § 80a-17(d); see also *SEC v. Talley Indus., Inc.*, 399 F.2d 396, 404-05 (2d Cir. 1968), *cert. denied*, 393 U.S. 1015 (1969) (sustaining the SEC's requirement for advance approval of parallel purchases by mutual fund and affiliate seeking control). The SEC may grant exemptions.

²⁸ See 1940 Act §§ 2(a)(2)-(3), 17(a)-(b), 15 U.S.C. §§ 80a-2(a)(2)-(3), 80a-17(a)-(b) (1988); see also 17 C.F.R. § 270.17a-6 (1990) (codifying exemptions to restrictions on affiliated persons).

Each mutual fund in a constellation of separate mutual funds with a common advisor might take 4.9% of the portfolio company's stock. The common advisor to the funds could then wield a large block of stock. But I understand that while some mutual fund complexes have multiple holdings in several different mutual funds, they usually avoid having the aggregate ownership of the complex reach 10%, perhaps because of fear of entering legal gray areas.²⁹

The 1940 Act prohibits cross-ownership. No investment company may buy any voting stock of a corporation if each would own more than 3% of the voting stock of the other.³⁰ A portfolio company unhappy with the prospect of a mutual fund exerting control could force the mutual fund out by preemptively buying 3% of the fund's stock.³¹ In effect, mutual funds need the consent of portfolio firm management before the mutual fund can enter the boardroom.

Moreover, if the mutual fund wished to act jointly with an affiliate to exercise control, it would need prior SEC approval.³² We can imagine an incipient network of institutional investors: An investment bank, an insurance company, or a commercial bank might become the investment adviser to a mutual fund. The adviser might take the 4.9% of the stock that the mutual fund holds, and combine that with a similar-sized holding of the investment bank, affiliated mutual funds, the insurance company, the commercial bank's trust department, or the bank's holding company. That combined block might be large enough to be influential, getting a

²⁹ The common block might be attributed to the advisor and lead to affiliate status with the portfolio company anyway. By violating the spirit of the 1940 Act's 10% rule, the advisor might fear regulatory hostility, even if there were no regulatory action. The group might be aggregated for purposes of Section 16(b) of the 1934 Act, which requires a return of six month trading profits for 10%+ owners.

³⁰ See H. BULLOCK, *THE STORY OF INVESTMENT COMPANIES* 90 (1959); 1940 Act § 20(c), 15 U.S.C. § 80a-20(c) (1988).

³¹ I understand that at least one target firm has neutralized mutual fund ownership in a hostile takeover through the cross-ownership prohibition.

³² See 1940 Act § 17(a)(1)-(2), (b); 15 U.S.C. § 80a-17(a)(1)-(2), (b) (1988); 17 C.F.R. § 270.17d-1(a) (1990); *Wellman v. Dickinson*, 475 F. Supp. 783, 834 (S.D.N.Y. 1979), *aff'd*, 682 F.2d 355 (2d Cir. 1982), *cert. denied*, 460 U.S. 1069 (1983) (holding the joint action need not have any influence on the affiliate's conduct, as "[t]he Act is designed to proscribe the appearance of or conflicts of interest"). There are some exceptions, but not when the investment company commits more than 5% of its assets to the joint enterprise, puts a director on the board of the affiliate, or the investment advisor to the mutual fund or any other affiliate has its own money also at risk, such as when it buys stock in the portfolio company. 17 C.F.R. § 270.17d-1(d)(5) (1990).

representative into the boardroom. But this consortium would have to obtain SEC approval of its activities, control actions, and plan. If the joint participants only wanted to campaign to get a director elected, then it would be hard to see why the SEC would deny the request. The approval would be a cost, but not a show-stopper. But if a participant expected to do business with the portfolio company, by lending, for example, then one should expect—for good reason, perhaps—SEC hostility. In the absence of a blanket SEC authorization, the need for SEC approval is one more burden on institutions that seek influence in the boardroom. The 1940 Act rules discourage financial networks.

II. ORIGINS IN THE 1936 REVENUE ACT

A. *Subchapter M of the Internal Revenue Code*

If a mutual fund were to deploy most of its portfolio in large influential blocks, it would be taxed unfavorably on its *entire* portfolio, because the Tax Code allows only *diversified* mutual funds to pass income through, untaxed to the conduit mutual fund. The 1936 Revenue Act's notion of diversification, like the 1940 Act's notion, is not that found in modern textbooks on corporate finance; mutual funds have to have their investments in companies constituting no more than 5% of the portfolio *and* constituting no more than 10% of the *portfolio company's* outstanding stock.³³ Later, in 1942, the Tax Code was amended to allow half of the portfolio to be more concentrated; for that other half, no more than 25% of the fund's assets can go into a single company's stock.³⁴

Witnesses at the 1940 Act hearings suggested that the principal basis for the distinction between diversified and nondiversified companies was not tax policy, but regulatory policy. The distinction was to establish "good" mutual funds—those that did not exert

³³ See Revenue Act of 1936 § 48(e)(2)(A)-(B), Pub. L. No. 74-740, 49 Stat. 1648, 1669 (codified as amended at I.R.C. § 361(b)(1)-(2) (1939) (amended 1942)).

³⁴ See Revenue Act of 1942 § 170, Pub. L. No. 77-753, 56 Stat. 798, 878-879 (codified at I.R.C. § 851(b)(4) (1988)). Venture capital firms, which could monitor *small* firms, not the large firms that are our subject, are partially exempt from the no-control provision. See I.R.C. § 851(e) (1988).

control—which would be favorably taxed, and all other mutual funds, which would be unfavorably taxed.³⁵

If a mutual fund's income were taxed at the ordinary corporate tax rate, that is, if the fund could not get pass-through status, the fund would be decimated by a triple taxation of income. Income received as dividends would be taxed twice: once when earned by the portfolio company, and then again when received by the mutual fund. The mutual fund could exclude most of the dividends received, netting out to an effective tax rate of 10% on dividends. Capital gains would be taxed at 34%. The income would then be taxed again at ordinary rates when paid to shareholders of a nondiversified fund.³⁶ The tax on intercorporate dividends has a history parallel to mutual fund regulation and taxation. Until 1935, intercorporate dividends were *not* taxed. Then the New Deal Congress taxed dividends to discourage complex corporate structures.³⁷

The tax result would also deter most ordinary corporations from taking large long-term ownership blocks. A corporation might accept the unfavorable tax status in the short-run, as a prelude to a takeover and restructuring. But the corporation asserting control over the long-term would have to be confident that it had unusually acute monitoring skills. After all, if the monitor received half of its income in capital gains and half in dividends, then it would have to pay approximately 20% of its income in taxes. A great deal of effective monitoring would be needed to make up for that initial

³⁵ See *1940 Act Hearings*, *supra* note 10, pt. 2, at 435-36 (statement of Raymond McGrath, Executive Vice-President, General American Investors, arguing against the SEC's regulatory view).

³⁶ See I.R.C. §§ 243, 852(a)-(b) (1988). Here is the calculation, based on today's rates for a non-subchapter M corporation. The fund's tax rate is 34%. Seventy percent of its dividends received from portfolio companies are excludable. These dividends face an effective tax rate of 10.2% ($.3 \times .34 = .102$). If the fund owned more than 20% of the stock of some portfolio companies, the dividends from those companies would have an exclusion rate of 80%. These dividends would face an effective tax rate of 6.8% ($.2 \times .34 = .068$). Capital gains would now be taxed at a rate of 34%. Since capital gains can be deferred by postponing the sales, the effective rate is less than 34%.

³⁷ See B. BITTKER & J. EUSTICE, *FEDERAL INCOME TAXATION OF CORPORATIONS AND SHAREHOLDERS* § 5.06, at 5-22 n.61 (5th ed. 1987).

penalty. Nor could the company organize itself as a public partnership, which would be able to pass its income through to owners without itself paying tax. To get such pass-through tax status, a publicly-traded partnership *must* comply with subchapter M's portfolio restrictions.³⁸

So, if a mutual fund wished to sell services as an intermediary/monitor, by dividing its portfolio into three or four stocks, it could not get the advantage of subchapter M. And no mutual fund could *ever* threaten a portfolio company that it would devote more than a quarter of its assets to obtaining a majority of the portfolio company's stock in order to oust management. That threat, and the influence it would yield, is *always* prohibited for a subchapter M mutual fund.³⁹

The costs of operating a control-fund are cumulative. First come the tax costs: dividends would be taxed at rates between 6.8% and 10.2%; capital gains would be taxed at the ordinary rate. Then come the other costs of taking large blocks: section 16(b) of the 1934 Act would force disgorgement of all short-swing trading profits made when the fund owned 10%+ of a portfolio company, regardless of whether the trading was done on inside information.⁴⁰ The costs of the fund networking with other financial institutions would not be trivial. (Section 13(d) requires the network to register with the SEC. The fund cannot affiliate with a commercial bank or its trust department.⁴¹) And foregoing the tax advantages of subchapter M would not relieve the fund of the costs of the 1940 Act: the fund would still have to register as an investment company under the 1940 Act and comply with the Act's terms.

These laws do not prohibit all large blocks in mutual funds. But they do constrain the supply of blocks, and raise the cost of networking with others to send a representative into the boardrooms of the largest public companies.

³⁸ The key tax provisions are at I.R.C. §§ 243, 1201 & 7704(c) (1988). *Private* partnerships surely can get pass-through tax status; such private control funds are now forming.

³⁹ See I.R.C. § 851(b)(4)(B) (1988). Nor can mutual funds issue senior securities to enhance absolute size, and hence the size of the chunk that goes into any single company. See 1940 Act § 18(a), 15 U.S.C. § 80a-18(a) (1988).

⁴⁰ See 1934 Act § 16(b), 15 U.S.C. § 78p(b) (1988). The tone of my comments is that taxing control funds is not wise. But I am not arguing that the other restrictions—such as the return of short-swing trading profits—are also necessarily unwise. Insider trading is not to be applauded. And overbreadth might be necessary to reduce insider trading, which is difficult to detect.

⁴¹ See 1934 Act § 13(d), 15 U.S.C. § 78m(d) (1988).

B. *Tax Doctrine: Are Mutual Funds Taxable as Corporations?*

1. Investment Trusts: Carrying on a Business?

A persistent difficulty in corporate taxation is determining which entities are taxable as "corporations." The term, said the Revenue Act of 1926, includes "associations, joint-stock companies and insurance companies."⁴² Trusts and mutual funds were threatened as associations, which would be taxable as corporations, instead of as pass-through, untaxed entities.

Case law and regulation made several distinctions, one of which is quite relevant for our purposes. A trust would not be separately taxed as a corporation if it was not carrying on a business (and met several other requirements).⁴³ This result was later codified: "Associations . . . include . . . common law trusts . . . which act or do business in an organized capacity."⁴⁴

Whe[n] trustees merely hold property for the collection of the income and its distribution among the beneficiaries of a trust, and are not engaged . . . in the carrying on of any business . . . no association exists. . . . Even in the absence of any control by the beneficiaries, when the trustees are not restricted to the mere collection of funds and their payment to the beneficiaries, but are associated together with similar or greater powers than the directors of a corporation for the purpose of carrying on some business enterprise, the trust is an association within the meaning of the statute.⁴⁵

Thus, the problem was that if the trust carried on a business—say by controlling an operating company and affecting its policies—then it was carrying on a business of managing companies. Trusts took the position that when only assembling a passive portfolio of

⁴² Revenue Act of 1926 § 2(a)(2), Pub. L. No. 69-20, 44 Stat. 9, 9 (codified at I.R.C. § 7701(a)(3) (1988)).

⁴³ See Treas. Reg. 69 art. 1504, *quoted in* L. WALLSTEIN, *SOME LEGAL QUESTIONS IN RELATION TO INVESTMENT TRUSTS* 11 (1928); *see also* Hecht v. Malley, 265 U.S. 144, 160-61 (1924) (reasoning that "the trustees were, in substance, merely holding property for the collection of the income and its distribution among the beneficiaries, and were not engaged, either by themselves or in connection with the beneficiaries, in the carrying on of any business").

⁴⁴ Treas. Reg. 69 art. 1502, *quoted in* L. WALLSTEIN, *supra* note 43, at 11 (emphasis omitted).

⁴⁵ Treas. Reg. 69 art. 1504, *quoted in* L. WALLSTEIN, *supra* note 43, at 11 (emphasis omitted). *See generally* Note, *Taxation—Taxability of Business Trust as "Association" within Meaning of Income Tax Act*, 84 U. PA. L. REV. 666, 667-68 (1935) (discussing tests for resolving whether a trust is an association).

diversified stocks and doing no more, the trust never became an association under the Tax Code.

2. *Morrissey v. Commissioner*⁴⁶

The IRS then took the doctrinally unsurprising position that the business of providing diversified investments was itself a business.⁴⁷ From this perspective, all trusts and mutual funds should be taxable at corporate rates. Eventually, in 1935, the Supreme Court agreed.⁴⁸ Investment trusts and mutual funds were organized to make a profit. Therefore they were associations under the Tax Code. Consequently, they would be taxed as corporations.

The cumulative effect of these decisions was to insulate only the unit investment trust from corporate taxation.⁴⁹ The unit investment trust puts together a portfolio of securities, sells subdivided interests in the portfolio, collects the earnings, and returns them to the beneficiaries. It does not ordinarily buy or sell securities for the trust.

These passivity doctrines persist in today's subchapter M. Fragmentation induces passivity, but fragmentation is not the only passivity-inducing element of subchapter M. Pass-through status under subchapter M is available only to companies that derive 90% of their income from investment in stocks, bonds and other securities.⁵⁰ On the face of the statute, there is a serious question whether a company that intended to make a significant portion of its income from *management*, as opposed to passive investment, would be entitled to subchapter M pass-through at all.

3. Liberalization in the 1936 Code

Against this background, the 1936 Tax Code should be seen as a "liberalizing" tax law for the mutual fund industry. The 1936 Tax Act exempted from corporate taxation those mutual funds which had fragmented portfolios. Yes, for tax purposes such funds were

⁴⁶ 296 U.S. 344 (1935).

⁴⁷ See Gen. Couns. Mem. 1881 (1928), *quoted in* L. WALLSTEIN, *supra* note 43, at 19-22.

⁴⁸ See *Morrissey*, 296 U.S. at 369. The tax status of the investment company receiving most of its income as dividends was not much of an issue until intercorporate dividends were taxed in 1935. See B. BITTKER & J. EUSTICE, *supra* note 37 and accompanying text.

⁴⁹ See L. WALLSTEIN, *supra* note 43, at 23.

⁵⁰ See I.R.C. § 851(b)(2) (1988).

carrying on a business; but it wasn't a "real" business. It was the business of picking stocks and bonds, not of sitting in boardrooms and influencing operating decisions. As the president of a leading mutual fund then said: "[The Tax Code] now recognize[s us] as being, for purposes of taxation, *not a productive agency* which should shoulder a heavier tax burden, but merely a managing agency to collect dividends and gains for distribution to its shareholders."⁵¹

Tax relief for mutual funds had a fairness-based justification. The wealthy could get the benefits of professional management by hiring their own trustee to manage their portfolio. The middle-class could only get this professional help through a mutual fund. But after *Morrissey* made mutual funds taxable in 1935, and intercorporate dividends became taxable under the 1935 Tax Act, getting that professional help was inordinately expensive.⁵² Tax doctrine was reconciled with the goal of giving the middle-class collective access to professional investment management by returning to the view that picking a fragmented portfolio was not really a business after all.

The debate behind the 1936 Code shows the proponents of the final measure saying that "another safeguard that the amendment contains . . . is to prevent an investment trust or investment corporation being set up to obtain control of some corporation and to manipulate its affairs."⁵³ The safeguard could be against the "evil" of Wall Street control of industry or the deterioration of tax doctrine in not allowing the investment trust to carry on a true business. Later testimony in the committee suggests that the evil of Wall Street control of large pots of money that could influence industry was at least part of the evil to ward off.⁵⁴ I suspect that similar sentiments are powerful today.⁵⁵

⁵¹ *Investment Trust Hails New Tax Act*, N.Y. Times, July 23, 1936, at 31, col. 1 (emphasis added).

⁵² See *Revenue Act of 1936: Confidential Hearings on H.R. 12395 Before the Senate Comm. on Finance*, 74th Cong., 2d Sess., pt. 10, at 60-62 (1936) [hereinafter *1936 Revenue Act Hearings*] (comments of Mr. Kent, Acting Chief Counsel to the Bureau of Internal Revenue); *id.* pt. 11, at 10-11 (comments of Mr. Kent and Sen. Walsh).

⁵³ *Id.* pt. 11, at 11 (comments of Mr. Kent).

⁵⁴ See *id.* at 36-37 (comments of Sen. LaFollette).

⁵⁵ See, e.g., Bartlett, *Books on Greed Worry Wall St.*, N.Y. Times, Feb. 12, 1990, at D1, col. 3 (listing books that indict the Wall Street community).

III. THE POLITICAL ROOTS OF DISARMING MUTUAL FUNDS

American public opinion has always been mistrustful of accumulations of economic power;⁵⁶ mechanisms such as mutual funds that would control industry are unpopular. In the 1930s, FDR thought that political stability was itself dependent on a dispersal of economic power. The key political players saw little good coming from banker influence in industry. Whether the issue was the chartering of the Bank of the United States, or interstate banking, or mutual fund control of industry, American politics has usually opted for fragmentation of financial power.

A standard move in public choice analysis is to find an interest group that has "bought" the legislation at the expense of a diffuse and disorganized citizenry. In the financial regulation of banks and takeovers, legal commentators have seen strong elements of this interest group approach.⁵⁷ But I believe this approach is less useful in understanding the 1940 Act. Mutual funds just were not financially important enough in the 1930s to evoke much interest group intervention. Rather, politicians were operating at the symbolic level. They were *creating* a mutual fund industry. Through regulation and taxation, politicians created a framework for mutual funds based on their concept of what a legitimate mutual fund ought to be. *Thereafter*, mutual funds had to grow up within that framework.

A. *Anti-Wall Street Sentiment*1. The Pecora Hearings and the Populists:
Father Coughlin and Huey Long

The Pecora hearings reflected and helped form a public opinion that mistrusted banking and securities practices on Wall Street. Wall Street bankers were defensive. The second J.P. Morgan said: "I consider the private banker a national asset *and not a national danger*. [Despite accusations to the contrary, the Wall Street banker has not] become too powerful . . ."⁵⁸ Ferdinand Pecora, counsel

⁵⁶ See S. LIPSET & W. SCHNEIDER, *THE CONFIDENCE GAP: BUSINESS, LABOR, AND GOVERNMENT IN THE PUBLIC MIND* 5-6 (rev. ed. 1987).

⁵⁷ See Romano, *The Political Economy of Takeover Statutes*, 73 VA. L. REV. 111, 120 (1987); Macey, *Special Interest Groups Legislation and the Judicial Function: The Dilemma of Glass-Steagall*, 33 EMORY L.J. 1, 1 (1984).

⁵⁸ *Stock Exchange Practices: Hearings Before the Sen. Comm. on Banking and Currency*, 73d Cong., 1st Sess. 5-6 (1934) [hereinafter *Pecora Hearings*] (emphasis added).

to the Senate Banking Committee for the hearings, later reflected the national mood: "[T]he terrific concentration of power in [bankers'] hands from many sources [was] *threatening* The bankers were neither [just] a national asset nor [just] a national danger—they were both."⁵⁹ Investment bankers' control over industrial companies was denounced,⁶⁰ because representation of banking interests on the boards of industrial companies perniciously magnified banker power. Popular opinion was virulently anti-banker and anti-Wall Street.⁶¹

Anti-banker leaders, such as Huey Long and Father Coughlin, emerged first on the periphery of national politics. But historians say that as their prominence grew they influenced developments in the 1930s due to Roosevelt's desire to coopt them and elements of their program. What explains the sudden rise to national prominence of Huey Long and Father Coughlin? In a recent history, Alan Brinkley concludes that while the two men had their repulsive, demagogic side, they also tapped deep-seated sensible sentiments of popular protest against distant financial institutions:

The most troubling feature of modern industrial society, Long and Coughlin maintained, was the steady erosion of the individual's ability to control his own destiny. Large, faceless institutions; wealthy, insulated men; vast networks of national and international influence: all were exercising power and controlling wealth that more properly belongs in the hands of ordinary citizens. These same forces had created the economic crisis of the 1930s and threatened, if left unchecked, to perpetuate it. . . . Power, they argued, should not reside in distant obscure places; the individual should not have to live in a world in which he could not govern or even know the forces determining his destiny. Instead, the nation should aspire to a set of political and economic arrangements in which authority rested securely in the community, where it could be observed and, in some measure, controlled by

⁵⁹ *Id.* at 6 (emphasis added); see also R. CHERNOW, *THE HOUSE OF MORGAN* 355-74 (1990) (discussing the *Pecora Hearings*, *supra* note 58).

⁶⁰ Voting trusts, for example, were denounced because they were used "to dominate the management if [the trustees] thought it necessary." *Pecora Hearings*, *supra* note 58, at 3836 (testimony of Harley Clarke, Chase Securities Corp); see also F. PECORA, *WALL STREET UNDER OATH—THE STORY OF OUR MODERN MONEY CHANGERS* 59, 208 (1939) (describing non-voting stock as "inventions of the devil"). Neither the bankers nor their interrogator discussed whether the alternative to banker control really was shareholder control—unlikely as Berle and Means were then demonstrating—or was instead managerial control.

⁶¹ See A. BRINKLEY, *VOICES OF PROTEST: HUEY LONG, FATHER COUGHLIN, AND THE GREAT DEPRESSION* 148-53 (1982).

its citizens. Concentrated wealth and concentrated power had damaged the nation's social fabric; a system of decentralized power, limited ownership, and small-scale capitalism could restore it.⁶²

Bankers in general and Wall Street bankers in particular caused the Depression; they had to be punished. Certainly bankers were too powerful. The two extolled the virtues of small business and small banks:

Essential to the survival of the community, therefore, was an economy of small-scale, local enterprise. How important such an economy was to Long and Coughlin was apparent in the frequency with which both men lamented its disappearance. The two found that small enterprise had been extinguished by concentrated wealth and power. One by one, they complained, the autonomous local institutions that sustained a meaningful community life were vanishing in the face of distant, impersonal forces. . . . Local financial institutions—what Long described as ‘the little banks in the counties and the parishes’ and what Coughlin termed the ‘small bankers outside the great ring of Wall Street’—were in dire peril. So were the ‘small industrialists,’ who had, Coughlin claimed, ‘been bought out or . . . destroyed by questionable competition.’⁶³

Roosevelt had reason to coopt Long and Coughlin:

It was that possibility—that Long and Coughlin would not only continue to gain support, but that their movements would begin to complement each other and to merge—that politicians like Franklin Roosevelt and James Farley found particularly alarming. Separately, Long and Coughlin were formidable foes; together, many feared, they might mobilize a popular following of truly remarkable proportions.⁶⁴

The politics of the “Second” New Deal’s legislative program, begun in 1935, was to coopt the less ugly elements of Long’s and Coughlin’s program. Against that background, the next year’s Revenue Act fragmented mutual funds. When the mutual fund provisions of the 1936 Revenue Act were discussed in committee, Senator LaFollette argued specifically against mutual funds that facilitated investment banker control of the public’s money in the hands of a few financiers.⁶⁵

⁶² *Id.* at 144.

⁶³ *Id.* at 145 (citation omitted).

⁶⁴ *Id.* at 209.

⁶⁵ *1936 Revenue Act Hearings*, *supra* note 52, pt. 11, at 36-37 (citing the PECORA

2. The Thinking at the SEC: Douglas and Anti-Wall Street Sentiment

William O. Douglas, chairman of the SEC and a key player in 1930s financial legislation, including the 1940 Act, articulated a general goal of fragmenting economic power: people who dominate financial markets have "tremendous power." "Such [people] become virtual governments in the power at their disposal. . . . [Sometimes it is] the dut[y] of government to police them, at times to break them up, to deter their further growth."⁶⁶

Bankers should provide and direct the flow of capital, but not control the enterprise after the capital has flowed to it, said Douglas.⁶⁷ His view is not just historical. In 1980, the Senate Government Affairs Committee examined corporate ownership, and its staff reported that "Congress [has been] concerned that the tremendous growth in securities held . . . by the larger banks, insurance companies, pension funds, and investment advisors might result in a concentration of economic power by a few institutional traders . . . over the managements of the companies whose stock they held, and indeed over American industry itself."⁶⁸

3. Linkage to the 1936 Code and the 1940 Act

In 1935 and 1936 Roosevelt sent Congress tax proposals that had a populist, soak-the-rich, anti-business tone. As I said, historians believe Roosevelt wanted to coopt growing populist forces.⁶⁹ In 1935 Long seemed likely to seek the presidency the

REPORT, *supra* note 7). To view the 1936 legislation as part of the coopting of Long and Coughlin is a bit precarious. By 1936, Long was dead and Coughlin was in decline. The reaffirmation in 1940 couldn't have directly resulted from an early 1930s political movement. And the cooption, if that's what it was, occurs on an ideological dimension that was widespread in the United State, stretching back to the Jeffersonians and 1890s populists and forward to today.

⁶⁶ W. DOUGLAS, *supra* note 4, at 15. "The needs of a small Middle Western community are apt to be better served by a banker at the head of a small local bank than by the same banker at the head of the nation's biggest bank." *Id.* at 14.

⁶⁷ See *id.* at 44-45.

⁶⁸ STAFF OF SEN. COMM. ON GOVERNMENTAL AFFAIRS, 96TH CONG., 2D SESS., STRUCTURE OF CORPORATE CONCENTRATION: INSTITUTIONAL SHAREHOLDERS AND INTERLOCKING DIRECTORATES AMONG MAJOR U.S. CORPORATIONS 2 (Comm. Print 1980) (emphasis added).

⁶⁹ See *supra* note 61 and accompanying text; A. SCHLESINGER, THE AGE OF ROOSEVELT: THE POLITICS OF UPHEAVAL 329 (1960); R. PAUL, TAXATION IN THE UNITED STATES 188 (1954) ("A well-known historian, Charles Beard, . . . commented that the [1935 tax] act served 'as a stick to beat off the storm troops of Senator Long

next year; the 1935 proposals were said to steal his thunder,⁷⁰ and to shock both Congress and the business community.⁷¹ Roosevelt proposed changes in the Tax Code, because, said FDR, the Tax Code has "done little to prevent an unjust *concentration* of wealth and *economic power*."⁷² The 1936 provisions that fragmented mutual fund portfolios should be seen in this anti-Wall Street context.

B. Public Interest Perspectives

1. Protecting Unsophisticated Investors

Anti-Wall Street pressures were not the only reason for mutual fund regulation; populist pressure cannot explain everything. Surely some mutual funds wanted to regularize their industry, making it attractive to the average saver by reducing the risks of banker wheeling and dealing. And Congress wanted to protect investors, fearing that unsophisticated investors would invest in mutual funds expecting diversification but be unable to evaluate the portfolio. The SEC testified that a mutual fund's *only* positive function was to provide diversification; any extension risked thievery.⁷³

Keeping mutual fund managers out of controlling positions kept them free of conflicts of interest. The fund's investment adviser, an investment bank, would use the control exerted by the mutual fund to obtain securities underwriting business from the controlled portfolio company.⁷⁴ Or the investment advisor of the fund with control would unload unwholesome securities of that controlled company onto a gullible public.⁷⁵

Key senators wanted regulation that would eliminate mutual fund looting at *any* cost, irrespective of whether the looting

and Father Coughlin.").

⁷⁰ See A. SCHLESINGER, *supra* note 69, at 325-28. Long was assassinated in 1935.

⁷¹ See *id.* at 329.

⁷² 79 CONG. REC. 9657 (1935) (message from the President, June 19, 1935) (emphasis added); see also J. WITTE, *THE POLITICS AND DEVELOPMENT OF THE FEDERAL INCOME TAX 100* (1985) (discussing Roosevelt's proposals and message to Congress).

⁷³ See *1940 Act Hearings*, *supra* note 10, pt. 1, at 132 (statement of George Mathews, Member of the SEC); *id.* pt. 2, at 807 (statement of David Schenker, Chief Counsel, SEC Investment Trust Study, reiterating Mathews' conclusions).

⁷⁴ See PECORA REPORT, *supra* note 7, at 333; *1940 Act Hearings*, *supra* note 10, pt. 1, at 36; *id.* at 206-07 (statement of L.M.C. Smith, Associate Counsel, Investment Trust Study).

⁷⁵ See PECORA REPORT, *supra* note 7, at 381-82.

amounted to 1% or 30% of fund assets.⁷⁶ (Undoubtedly, one should not naively expect public-spirited behavior from rapacious bankers. The difficulty in the legislative history is that it does not equally mistrust the rapacity of corporate managers and fails to consider whether the greed of each could be used to neutralize each other.)

Senators also wanted to protect individual investors in mutual funds from the machinations of insider-manipulators. Denying financiers power to control industry was thought to reduce their ability to manipulate the controlled business. Financiers would control companies to issue unneeded, overpriced securities that would be dumped into controlled mutual funds, solely to generate fees for the financiers.

The mutual fund industry didn't strongly oppose all of the restrictions, in fact it preferred some elements. It wanted to sell its product and needed a code of conduct to certify the industry to the public.⁷⁷ To make money off of the unsophisticated, the mutual fund industry didn't need complex relations with portfolio companies; authority to use a heavy load was enough. Although resale price maintenance has been illegal in antitrust (but attacked as not necessarily good policy), the mutual fund industry had federally-mandated noncompetition among dealers: the advisor sets the load, dealers cannot cut it. Price competition among mutual fund dealers is a criminal offense.⁷⁸ These elements can be seen as part of the political payoff to the mutual fund industry for the operating restrictions. And, as I note below, one type of mutual fund—the Massachusetts trust—preferred that Congress require all mutual funds to use a structure that the Massachusetts trust had already adopted.

⁷⁶ See *id.* at 333-37 (comments of Senator Wagner and others).

⁷⁷ See Bosland, *The Investment Company Act of 1940 and Its Background*, 49 J. POL. ECON. 687, 687 (1941). (Certification also has a cartel quality of eliminating some rough competition.)

⁷⁸ See 1940 Act § 22(d), 15 U.S.C. § 80a-22(d) (1988). See also S. REP. NO. 184, 91st Cong., 2d Sess., reprinted in 1970 U.S. CODE CONG. & ADMIN. NEWS 4897, 4904 (discussing § 22(d) in the context of S. 2224, the Investment Company Amendments Act of 1970).

2. Promoting Political Stability

The 1940 Act and the 1936 Revenue Act remedies contrast with the remedies in other 1930s securities legislation. The 1933 and 1934 Acts also attacked the manipulation of investors, but used disclosure as the principal solution to roughly similar problems. To explain the differing remedy for mutual funds, either we have to identify a significantly different problem for remedy—e.g., investors in mutual funds are especially unsophisticated or Blue Sky merit regulation filled out 1933 and 1934 Act disclosure in the same way that the 1940 Act went beyond disclosure—or identify forces other than the public interest that were also at work.

Slaking the public's anti-Wall Street appetite would promote political stability without compromising the central features of capitalism. Political stability is not now in question in the United States; in the 1930s it was. FDR himself said:

It is time to . . . reverse that process of concentration of power which has made most American citizens, once traditionally independent owners of their own businesses, helplessly dependent for their daily bread upon the favor of a very few, *who, by devices such as holding companies*, have taken for themselves unwarranted economic power. I am against private socialism of concentrated economic power as thoroughly as I am against government socialism. The one is equally as dangerous as the other; *and destruction of private socialism is utterly essential to avoid government socialism.*⁷⁹

If Roosevelt was right, then political stability in the United States—surely a worthwhile objective—was dependent, at least in the 1930s, on fragmenting finance. One way to fragment finance was to eliminate investment banker control of industry through mutual funds.

But the financial reality of the 1930s suggests that destruction of mutual fund power to control was symbolic. Mutual funds indeed had taken some first steps in influencing industry, and, yes, they had the *potential* to be big players in finance and industry. But the aggregate assets that mutual funds controlled in the 1930s were just too small to be a big threat to political stability. In 1940, there were only 68 mutual funds, with total assets of only \$450 million.⁸⁰

⁷⁹ E. HAWLEY, THE NEW DEAL AND THE PROBLEM OF MONOPOLY 281 (1966) (emphasis added).

⁸⁰ See W. BAUMOL, S. GOLDFELD, L. GORDON & M. KOEHN, THE ECONOMICS OF MUTUAL FUND MARKETS: COMPETITION VERSUS REGULATION 8 (1990).

So, it was not the *immediate* prospect of "unwarranted economic power," to use Roosevelt's words, but the symbolic potential, or, at best, the prospect that *in alliance* with other financial institutions, the mutual fund would play a serious role.

A prominent historical view is that, at crucial times in American history, business interests became so powerful that a political counterweight arises. Before big business could crush others in the economic system, politicians saved the nation from injustice by checking (but not destroying) those business interests. According to this view, Andrew Jackson rose to check the crushing weight of Eastern finance on the average American.⁸¹ Woodrow Wilson later created the Federal Reserve System to take power away from Morgan, who had become the nation's *de facto* central bank.⁸² And then in the Great Depression, Franklin Roosevelt built an administrative structure as a counterweight to financial interests that were said to have brought on the Depression.⁸³ Certainly leading politicians believed they were fighting for the country's soul against a Wall Street conspiracy. Said FDR:

The real truth . . . is, as you and I know, that a financial element in the larger centers has owned the Government ever since the days of Andrew Jackson—and I am not wholly excepting the administration of W[oodrow] W[ilson]. The country is going through a repetition of Jackson's fight with the Bank of the United States—only on a far bigger and broader basis.⁸⁴

In the 1936 campaign, Roosevelt "lashed out at the economic royalists who gathered other people's money to impose a new industrial dictatorship."⁸⁵ Roosevelt closed the campaign with a powerful emotional speech: "[O]rganized money . . . hate[s] . . .

⁸¹ See A. SCHLESINGER, *THE AGE OF JACKSON* 88-102, 334-41 (1945).

⁸² See A. LINK, *WOODROW WILSON AND THE PROGRESSIVE ERA, 1910-1917*, at 43-53 (1954); R. CHERNOW, *supra* note 59, at 128-30.

⁸³ See A. SCHLESINGER, *THE CRISIS OF THE OLD ORDER, 1919-1933*, at 289-90 (1957); A. SCHLESINGER, *THE COMING OF THE NEW DEAL* 489-91 (1959). In one historical view politicians are populists or tools of interest groups; in the other view politicians are heroic figures saving America from powerful business interests. These two views can be reconciled for our purposes. In the social justice vision, right-hearted politicians save farmers and workers from the onslaught of capital. In the other vision, cynical politicians check capital so that favored groups (labor and managers) will be benefitted. The *factual* story for each historical vision is roughly similar. The spin, the connotation, the sense of rightness, is what is variant.

⁸⁴ W. LEUCHTENBURG, *FRANKLIN D. ROOSEVELT AND THE NEW DEAL, 1932-1940*, at 80 (1963) (emphasis added).

⁸⁵ *Id.* at 183-84.

me. . . . I should like to have it said of my first Administration that . . . [the forces of organized money] met their match. . . . [And] I should like to have it said of my second Administration that in it these forces met their master."⁸⁶

3. Fighting Cartels

One reason to block control was to block cartelization. A mutual fund could be the means by which an investment banker controlled several companies in a single industry, as Morgan did. That control could be used to promote and police a cartel.⁸⁷

Louis Brandeis is often cited as setting the tone and providing a plan for action.⁸⁸ "The dominant element in our financial oligarchy is the investment banker. Associated banks, trust companies and life insurance companies are his tools."⁸⁹ Bankers should be middlemen, raising capital only; there should be no interlocking of financial institutions into powerful economic centers.⁹⁰

Woodrow Wilson also believed small groups of people in large corporations made autocratic decisions, concentrating in their own hands the "resources, the choices, the opportunities, in brief, the power of thousands."⁹¹ Trusts were growing in size and power, and had to be stopped. Brandeis prescribed the remedy: "We must," he said, "break the [m]oney [t]rust or the [m]oney [t]rust will break us."⁹²

The anti-cartel theory can be seen even today in subchapter M. Congress liberalized the portfolio fragmentation requirements in 1942, at the behest of the mutual fund industry.⁹³ But it was quite

⁸⁶ *Id.* at 184.

⁸⁷ See PECORA REPORT, *supra* note 7, at 360-63, 381; R. CHERNOW, *supra* note 59, at 66-68.

⁸⁸ See V. CAROSSO, THE MORGANS—PRIVATE INTERNATIONAL BANKERS 1854-1913, at 639-40 (1987); F. PECORA, *supra* note 60, at 39 (noting favorable Senatorial thoughts about L. BRANDEIS, OTHER PEOPLE'S MONEY AND HOW THE BANKERS USE IT (1914), during the Pecora hearings).

⁸⁹ L. BRANDEIS, *supra* note 88, at 4.

⁹⁰ See *id.* at 6-9, 47-50.

⁹¹ W. Wilson, *The Lawyer and the Community*, 192 N. AM. REV. 604, 612 (1910); see also W. DIAMOND, THE ECONOMIC THOUGHT OF WOODROW WILSON 67 (1943) (presenting Wilson's argument that financiers control railroads and industry to the detriment of the nation).

⁹² L. BRANDEIS, *supra* note 88, at 201.

⁹³ See Revenue Act of 1942 § 170(a), Pub. L. No. 77-753, 56 Stat. 798, 878 (codified at I.R.C. § 851(b)(4)(B) (1988)).

careful to stymie mutual fund control of industry. No more than 25% of the mutual fund's portfolio could go into the stock of a single company. Nor could 25% go into the stock of two or more controlled companies "engaged in the same or similar trades or businesses or related trades or businesses."⁹⁴ The fund could put all of its assets into a single industry and get pass-through tax status and diversified status under the 1940 Act. But it could not control companies in that single industry. And owning 20% of the stock of a portfolio company gave the mutual fund control for purposes of the fragmentation requirement. The legislative history shows an example:

Investment company W . . . has its assets invested as follows: 20 percent in cash and Government securities, 5 percent in corporation A, 10 percent in corporation B, 25 percent in corporation C, and the other 40 percent in the securities of miscellaneous corporations, not exceeding 5 percent in any one issuer. Investment company W owns more than 20 percent of the voting power of corporations B and C. Corporation B manufactures radios and corporation C acts as its distributor and also distributes radios for other companies. Investment company W fails to meet the requirements of section 361(b)(4) since it has 35 percent of its assets invested in the securities of two issuers which it controls and which are engaged in related trades or businesses.⁹⁵

If monitoring by mutual funds were functionally possible, this tax rule would be a barrier. Monitoring requires specialized staff, with industry knowledge. If the fund cannot concentrate its influential blocks in a single industry, or its vertically related parts, assembling a staff would be difficult or impossible.

The post-1942 structure of subchapter M produces odd results. If the mutual fund keeps its entire portfolio fragmented, it can put its entire portfolio into a single industry. A few mutual funds do this—Fidelity's "Select" funds come to mind. Shareholders of these funds get little diversification. Because the fund managers are exclusively investing in a single industry, they might acquire enough expertise so that they can second-guess some portfolio company managers every now and then. Functionally, the fund might get enough expertise to feel comfortable with a few influential positions. After all, the shareholders are not getting much diversifica-

⁹⁴ *Id.*

⁹⁵ HOUSE COMM. ON WAYS AND MEANS, THE REVENUE BILL OF 1942, H.R. REP. NO. 2333, 77th Cong., 2d Sess. 122 (1942).

tion from the fund anyway: its portfolio is all in one industry. But the fund managers cannot put more than 25% of its assets into control blocks in a single industry; the fund *cannot concentrate* investments in a single industry without tax penalty.

C. Interest Groups

1. The Managers: But Dimly

From a modern perspective, one would have expected managers to have been ardent supporters of the fragmentation of mutual funds. Corporate managers want independence from their shareholders. Certainly one can readily find managerial support for anti-takeover legislation,⁹⁶ and managers benefitted from financial fragmentation. But the evidence does not show direct, powerful lobbying, or even testifying by managers in 1936 or 1940. Perhaps managers did not exert their influence because in the 1930s mutual funds were small players in the financial world, and the political action then was mostly symbolic.

But that does not mean we should dismiss the managerial public choice story completely. At least some politicians who promoted the 1940 Act appealed to managerial freedom from Wall Street control, and there is evidence that the 1936 and 1940 Act fragmentation provisions had survival strength *because* they did not threaten managers.

William O. Douglas, as commissioner and chairman of the SEC in the 1930s, had a pivotal role in the regulation of financial institutions. Undoubtedly, he reflected the concepts and prejudices of many during that crucial time. While he was a commissioner, the SEC proposed the Investment Company Act and formulated rules limiting joint action.

Douglas's statements show two relevant principles: a displeasure with Wall Street, which roughly corresponds to our populist principle, and a displeasure with bankers controlling managers, which roughly corresponds to our managerial interest group story. Douglas *surely wanted* to destroy Wall Street control of Main Street, as he said in a 1937 speech, which I quoted in the introduction and repeat here:

⁹⁶ See Romano, *supra* note 57, at 121-22, 138-41; Ryngaert & Netter, *Shareholder Wealth Effects of the Ohio Antitakeover Law*, 4 J.L. ECON. & ORGANIZATION 373, 375-76 (1988); Wayne, *Pennsylvania Lends Force to Anti-Takeover Trend*, N.Y. Times, Apr. 19, 1990, at A1, col. 3 ("Pennsylvania business groups support[] the bill . . .").

[T]he banker *will* . . . [be] . . . restricted to . . . underwriting or selling. Insofar as management [and] formulation of industrial policies . . . it is my belief that *the banker will be superseded*. The financial power which he has exercised in the past over such processes will pass into other hands.⁹⁷

"Remote control by an inside few of these fundamental economic and human matters is fatal. There can be in our form of corporate and industrial organization no royalism which can long dictate or control these basic matters,"⁹⁸ he said. The power of Wall Street must be held at bay: "finance moves into the zone of exploitation whenever it becomes the *master* rather than the faithful and loyal *servant* of investors and business. To make finance such a *servant* rather than a *master* becomes a central plank in any platform for reform."⁹⁹

Members of Congress echoed this theme. Floor debates during the securities legislation of the 1930s show the House of Representatives applauding calls to limit the power of bankers.

[T]he failure of many of our great industrial corporations is due to investment-banker management. . . . [B]anker directors living remote from the properties operated have no understanding of the . . . industry they direct. . . . The deplorable situation of many of our great industrial corporations is directly due to their banker management. . . . Congress must make it unlawful for any person to act as a director . . . who shall also be [an investment banking] partner¹⁰⁰

2. Survivorship

Even if managers were not crucial to passage of the fragmentation rule in 1936 (and again in 1940), one can still see a managerial interest group picture, although only a dimly lit one. If the rule had seriously impinged on managerial authority, managers would have objected. And the evidence I'll discuss below suggests that the

⁹⁷ W. DOUGLAS, *supra* note 4, at 40-41 (emphasis added). As I noted previously, *supra* note 4, this speech was made in 1937 before a shocked group of Wall Street investment bankers.

⁹⁸ *Id.* at 10.

⁹⁹ *Id.* at 44; cf. McCraw, *The Public and Private Spheres in Historical Perspective*, in PUBLIC-PRIVATE PARTNERSHIP 31, 51-52 (H. Brooks, L. Liebman & C. Schelling eds. 1984) (noting that "[i]nstead of wreaking vengeance [for a discredited securities market] the [SEC] set out to restore legitimacy to Wall Street's essential function of channeling investment capital into enterprise").

¹⁰⁰ 77 CONG. REC. 2933-34 (1933) (remarks of Rep. Marland).

corporate managers might have killed the rule. Even at the height of the New Deal, if a rule threatened managers it would have been unstable, subsequently challenged, and then probably reversed.

Consider the experience of two tax rules passed in 1936. One threatened managers, the other—mutual fund fragmentation—did not. The threatening provisions were attacked, watered down, and then repealed. The non-threatening, manager-friendly portfolio fragmentation rules have persisted nearly intact for fifty years; they've been watered down only once, in 1942, and then only slightly.

The 1936 Revenue Act taxed undistributed corporate profits. If a corporation retained 60% or more of its net income, the retained earnings were taxed at a rate of 27%.¹⁰¹ The tax, not surprisingly, pushed managers to distribute most of their profits. Companies that needed funds were dependent on capital markets to replenish the monies dividended out. When they returned to the capital markets, bankers and securities buyers would scrutinize the managers' results, and penalize them (in the form of higher capital costs) if the results were poor.

Companies with diminished prospects for future profit would face difficulty in raising new funds. One suspects that during the Depression many companies met the economic requisites for contraction; once they dividended out their funds, they would be forced to contract. Managers unhappily found themselves controlling a smaller enterprise.

Either way managers were unhappy with a serious tax on retained earnings. If they needed new funds for expansion, they disliked the increased scrutiny of bankers and other investors. If their company were one that should have been contracting, managers disliked the quickened pace of contraction induced by a retained earnings tax, which forced fast and heavy dividends when the capital markets would not provide new funds.

¹⁰¹ See Revenue Act of 1936 § 14(b), Pub. L. No. 74-740, 49 Stat. 1648, 1656 (repealed 1939). The tax was graduated:

<u>Percentage of net income not distributed</u>	<u>Tax on the undistributed income</u>
10% or less	7%
10 to 20%	12%
20 to 40%	17%
40 to 60%	22%
60% or more	27%

While this view of capital markets and managers has a modern ring,¹⁰² it was intuitively well-understood during the 1930s. A representative of management said during the 1936 hearings that the undistributed profits tax would cause conflict "between those engaged in the management of a business and those who are purely investors."¹⁰³ Berle and Means recognized and advocated finding ways to subject managers to the capital markets:

Only one general protection beside the power of active revolt remains to guarantee a measure of equitable treatment to the several classes of security holders. The enterprise may need new capital. The management must, therefore, maintain a situation in which additional capital is forthcoming. . . . This need for new capital sets a very definite limit on the extent to which those in control can abuse the suppliers of capital. . . . How adequate a protection this is, however, depends on factors that are wholly beyond the investor's control: the state of the industry, the position of the particular corporation, and the attitude of the management.¹⁰⁴

And one might add to Berle and Means's list, the extent to which an undistributed profits tax forces distribution, subjecting managers to the capital markets.

Tugwell, the Administration's principal proponent of an accumulated earnings tax, and at times an academic and administrative colleague of Berle, offered managerial discipline as a rationale for the undistributed profits tax. His principal goal was to reduce excessive corporate savings, which he thought would increase consumer spending. But he and others in the Administration thought the tax "would give the stockholders more influence in the formulation of corporation dividend and corporation saving policies."¹⁰⁵

¹⁰² See Easterbrook, *Two Explanations for Dividends*, 74 AM. ECON. REV. 650 (1984); Levmore, *Monitors and Freeriders in Commercial and Corporate Law Settings*, 92 YALE L.J. 49 (1982).

¹⁰³ *Revenue Act of 1936: Hearings on H.R. 12395 Before the Senate Comm. on Finance*, 74th Cong., 2d Sess. 514, 520 (1936) (statement of Herman H. Lind, General Manager, National Machine-Tool Builders Ass'n).

¹⁰⁴ A. BERLE & G. MEANS, *supra* note 3, at 280-81.

¹⁰⁵ S. RATNER, *TAXATION AND DEMOCRACY IN AMERICA* 474 (1967); see also D. FUSFELD, *THE ECONOMIC THOUGHT OF FRANKLIN D. ROOSEVELT AND THE ORIGINS OF THE NEW DEAL* 211-12 (1956) (discussing Tugwell's plan for an undistributed profits tax which would lead to higher output and greater productivity from private business); A. SCHLESINGER, *supra* note 69, at 506-07 (describing Tugwell's plan as an attempt "to force corporate profits into purchasing power as wages or dividends").

Managers and their political allies vehemently objected to this undistributed profits tax.¹⁰⁶ "Few taxes have evoked such a storm of passionate and partisan controversy as that on the undistributed profits tax. Spokesmen for corporations objected strenuously on the ground that the tax made for economic instability, [and] interfered with corporate policies"¹⁰⁷ In 1938, the Chamber of Commerce, the National Association of Manufacturers, the American Mining Congress, and the New York Board of Trade all opposed the tax.¹⁰⁸ They succeeded: first they got Congress to cut the rate.¹⁰⁹ The next year they got Congress to repeal the tax.¹¹⁰ Managers' decisions on how much of the profits to pay out to shareholders would no longer be affected by the corporate tax. Managers could retain earnings, and were more free from the discipline of the capital markets.

The survivorship argument should now be clear. Proposals can originate in the Treasury Department without any interest group pressure. The Treasury may well make its proposals based solely on what Treasury officials think would be best for the country, based on their own policy predilections. But for a proposal to survive it must not gore the ox of a powerful interest group. The tax on undistributed profits threatened managers; within a few years they killed it. In contrast, the Treasury's simultaneous proposal to tax mutual funds with only fragmented portfolios did not incur the ire of managers; it survived.

To be sure, this story does not make managers the moving force behind the mutual fund tax bill, as they often are in modern anti-takeover legislation. But it suggests that managers could well have killed mutual fund fragmentation if they felt threatened. They did nothing about mutual fund fragmentation either because they liked

¹⁰⁶ See R. BLAKEY & G. BLAKEY, *THE FEDERAL INCOME TAX* 410, 411 (1940) (citing hearings).

¹⁰⁷ S. RATNER, *supra* note 105, at 474; see R. BLAKEY & G. BLAKEY, *supra* note 106, at 411 (citing 80 CONG. REC. 6317 (1936)); Enright, *Business Opposes Tax on Surpluses*, N.Y. Times, Mar. 8, 1936, at 9, col. 4.

¹⁰⁸ See *Revenue Revision, 1939: Hearings Before the House Comm. on Ways and Means*, 76th Cong., 1st Sess. 102, 104 (1939) (testimony of E. Alvord of Chamber of Commerce); *id.* at 145, 150-51 (testimony of Noel Sargent, Secretary of National Association of Manufacturers); *id.* at 133, 135 (testimony of Julian D. Conover of American Mining Congress); *id.* at 174, 177 (testimony of M. L. Seidman of the taxation committee of the N.Y. Board of Trade).

¹⁰⁹ See Revenue Act of 1938 § 13(c), Pub. L. No. 75-554, 52 Stat. 447, 455.

¹¹⁰ See Revenue Act of 1939 § 201, Pub. L. No. 76-155, 53 Stat. 862, 864 (deleting undistributed profits tax from I.R.C.).

it, or because they were indifferent to it. Since mutual funds were small players in the 1930s, managers may have cared little about the structure of mutual fund portfolios back then.

3. Massachusetts Trusts

Massachusetts trusts typically had a diversified structure.¹¹¹ The trustees avoided controlling industry. When the 1936 Tax Act was considered and passed, one of the key players was Senator Walsh, chair of the Senate Finance Committee, from Massachusetts. He praised the Massachusetts trusts' structure and advocated mandating that all mutual funds have their structure. The 1936 Tax Code portfolio requirements essentially did that. Massachusetts trusts lobbied for the 1936 legislation with portfolio requirements roughly mimicking their own portfolio policies.¹¹² Massachusetts trusts could comply without a change in operation; others would have to bend. I believe a large number of mutual funds still operate out of Massachusetts.

IV. POLITICS AND ECONOMICS

I am seeking a political story to partly explain the fragmented ownership of the large public corporation in the United States. Politics produced financial fragmentation and financial fragmentation partly produced the large public corporation. The critical political elements are Federalism, interest groups and popular ideology, leavened by the public interest. Populism tended to weaken financial institutions. While populism could not itself weaken all of them, when there were plausible public-regarding benefits to fragmentation, or when an important interest group favored fragmentation, the result has usually been to fragment finance. Elsewhere I've claimed that these elements induced fragmentation of American finance, fostering the fragmented ownership of the public company.¹¹³ Here I claim that popular ideology and some public-interest views, leavened by some luke-warm interest group action, fragmented mutual funds.

But perhaps there is an overriding economic story, conceivably an efficiency one, to explain the political story. Why have Germany

¹¹¹ See D. ROBINSON, *MASSACHUSETTS INVESTORS TRUST: PIONEER IN OPEN-END INVESTMENT TRUSTS* 14 (1954).

¹¹² See *id.* at 16, 19-20.

¹¹³ See Roe, *A Political Theory*, *supra* note 5, at 31-32.

and Japan had much more powerful financial institutions that can heavily influence and indeed sometimes control industry? Several hypotheses are possible. The accidents of history may have led different systems to evolve in different countries. Perhaps the Japanese and German systems are inefficient, or just different but no better and no worse. Perhaps they lag an advanced American financial system, although we must wonder why they have caught up or surpassed us in industry but lag in finance. Or perhaps countries with a feudal past and a recent acquisition of democracy more willingly tolerate the hierarchical implications of industry influence and control by financial institutions. To the extent this is so, then we should now expect to see political pressure in Germany and Japan to reduce the power of their financial institutions.¹¹⁴

But there is another possibility, a "meta" economic explanation for the political result: perhaps American and Japanese political and financial institutions responded to the underlying economics in each nation. Could the relative scarcity of managerial talent and capital explain the varying institutional arrangements?

Capital and resources have been relatively abundant in America, while skilled labor, perhaps including skilled managers, have been relatively scarce. Post-World War II Japan lacked capital and resources, but had a relative abundance of skilled and disciplined managers and workers. Did the relatively scarce resource in the United States—managerial talent—lead to contracts that favored managers at the expense of the abundant resource—capital? Those favorable contracts could include managerial autonomy from capital. These contracts were written, this story would go, but written in the political environment. In Japan and Germany, with capital scarce, the arrangements would favor capital.

This economic "meta"-story could help explain why contracts favoring managers would arise in the United States more than in Germany or Japan. But it wouldn't explain why these contracts would be written by Congress, instead of privately by each company and its managers. Here is one possibility: political pressure always arises to fragment finance, but politicians in an environment where capital is relatively more scarce resist this legislation. Why? Some politicians are reluctant because of the public interest; those managers who want autonomy may not seek the legislation vociferously, since with capital scarce other forms of private financial

¹¹⁴ *Id.* at 65 n.206.

control will emerge anyway; institutions with capital resist the restrictions more strongly than they otherwise would. When capital is plentiful, the forces of fragmenting don't face these impediments.

What prediction would we make if capital became relatively more scarce in America and less scarce in Germany and Japan, a reversal occurring during the last decade? We should expect pressure, both financial *and political*, in Germany and Japan to change the relationships between capital and managers. Japanese and German managers would become more free from capital; and American financial institutions would develop more muscle. The first seems to be happening; the second possibility is generating talk.¹¹⁵

V. SOME POLICY IMPLICATIONS

My main purpose here has been to understand how politics and the 1930s conception of the proper role of mutual funds led to regulation and taxation that prohibited mutual funds from becoming important players in corporate governance. But this story has potential prescriptive implications. The SEC is now reviewing whether it should seek amendment to the 1940 Act.¹¹⁶ The SEC should consider corporate governance as well as investor protection as it rethinks mutual fund regulation.

Because I am dubious about the monitoring or informational potential of more powerful financial institutions,¹¹⁷ I am uncertain about what prescriptions are in order. True, Japan and Germany have had different relationships between financial institutions and industrial companies, and have not been irredeemably hobbled by these differences. But we cannot yet tell whether the German and Japanese arrangements were inefficient (although

¹¹⁵ At least one major discordant note sounds in this story. Many restrictions on capital arose in the United States in the 1930s, when capital *was* relatively scarce. Generalizations cannot explain everything.

¹¹⁶ See, e.g., Request for Comments on Reform of the Regulation of Investment Companies, [1990 Transfer Binder] Fed. Sec. L. Rep. (CCH) ¶ 84,607 (June 15, 1990) (requesting recommendations on whether the 1940 Act should be revised "[i]n light of the recent significant changes in the securities markets").

¹¹⁷ See Roe, *A Political Theory*, *supra* note 5, at 53-65. The monitoring story is the central one in the literature today. But I wonder whether the weak link is in the securities markets. Fragmented investors might not process firm-specific information well, because it's too expensive, technical, or proprietary. If this is so—it is—and important, then large block holders could help produce better run firms not by monitoring, but by understanding.

they couldn't have been debilitatingly so) or efficient only in the context of German and Japanese history, culture, and ability to systematically produce good regulation and good regulators.

In Germany investment companies play an important role in corporate governance. Banks aggregate the vote of stock they own directly, stock owned by investment companies that the bank controls, and stock owned by individuals but deposited with the bank as custodian.¹¹⁸ They aggregate these votes—frequently amounting to 40% of the vote in many companies—to elect directors of portfolio companies, directors not beholden to the portfolio companies' managers. This activity would be barred in the United States by the Glass-Steagall Act and would face serious, probably prohibitive obstacles under the 1940 Act because of the likelihood of conflicts of interest. How and whether this conflict is avoided in Germany is unclear.

A common misconception about German and Japanese banks is that their influence in industry comes only from control of credit. In Germany control over credit is a secondary factor; in Japan control over credit (which is weakening as a securities market for debt arises) may have been primary; but banks there control large blocks of stock as well. This misconception is understandable. Americans are so inured to banks being separated from commerce that credit intuitively seems to be the means of bank influence. But German banks enter the boardroom not through the usual advantage of a bank—control over credit—but through control of the proxy machinery.

Even if we thought that greater involvement of financial institutions would be salutary, we should be cautious. Financial institutions would not generally be better informed than incumbent managers who have spent a lifetime in their businesses; financiers could not systematically manage companies any better. At best, financiers will be less biased toward growth, their representatives on corporate boards would be more likely to be independent of managers and would have the incentive to make the board a good one. At worst, they will be affected by their own conflicts of interest—seeking deal-making for fees—and never contribute to the functioning of the enterprise.

In the governance of small firms financiers play important roles, despite that the entrepreneur is better informed about the business.

¹¹⁸ See Gottschalk, *Der Stimmrechtseinfluss der Banken in den Aktionärsversammlungen von Grossunternehmen*, WSI-MITTEILUNGEN, May 1988, at 294.

The financier there—called then a venture capitalist—appears to be functional. Such financiers know enough to avoid managing the enterprise, to only ask questions and put operating managers on a budget. Yet financiers disappear from the boardroom when the enterprise goes public. Perhaps financiers usually disappear from the boardroom because their involvement would be dysfunctional. But although they cannot always be dysfunctional, it is nearly always so that their involvement is legally restricted, as is the involvement of a mutual fund or its investment advisor.

If we were sure that financial institutions could improve operating companies, then we should examine the following question: should the fragmentation rules in the 1940 Act and the Tax Code be dropped? The diversification rule in the 1940 Act could be solely a disclosure matter, which could tie into modern notions of diversification; a fund that owned more than 10% of the portfolio company's stock could still be diversified. The large block limits and industry limits in subchapter M could be dropped. In the modern securities market, the central protection to buyers of the fund is adequate disclosure about the structure of the fund's portfolio.

The basic concept of diversification in the two acts is well-meaning but antiquated. The laws' notion of diversification—no more than 5% of a single issuer—offers little in the way of investor protection. As I've shown, a mutual fund could put all of its monies into a single industry, making the fund ridiculously undiversified. True, the restrictions on 10%+ blocks might really be responses to liquidity, not diversification problems. But these could also be accommodated. Disclosure of illiquidity problems might be possible. Permission to slow-down redemptions in some circumstances might be possible. Dividends by pro-rata distribution of stock position might be considered.

Conflicts of interest cannot be ignored. But mutual funds present relatively low risks of conflicts since they have little to offer the industrial firm. Mutual funds are not like banks and insurance companies, with loan officers searching for high-interest loans. True, some mutual funds (or, more accurately, their advisors) want access to inside information, others have pension plans to peddle, and others are affiliated with investment banks that could have something to sell. If these seem serious risks, deregulation could begin only with fully independent funds.

If prevention of conflicts of interest were the only goal, then continuation of the fragmentation rules would have some rationale.

But while conflicts of interest should not be ignored, they should not be the only factor weighed in the balance. Recent trends in corporate governance suggest that American companies could profit from more, not less, outside oversight, and mutual funds could be a good place to start. Unlike banks, mutual funds are not highly leveraged.¹¹⁹ A decline in value at a large undiversified mutual fund does not have the same risks as a decline in value of a highly leveraged bank. The decline in value at the mutual fund is absorbed by thousands of unlucky individuals; the absorption is smooth, the transaction costs low. The decline in value at a highly leveraged bank is absorbed by bank stockholders and the government insurance fund; the absorption of losses is bumpy, transaction costs are high, the moral hazard of excess risk-taking by insolvent banks is substantial. Failure of a money market mutual fund might have consequences similar to the failure of a bank; these consequences justify stringent safety regulation of money market funds. Such considerations don't spillover to justify prohibiting a "large block" fund whose riskiness has been well disclosed.

Would the current mutual fund industry want to be associated in investors' minds with such "large block" funds? The mutual fund industry itself would be wary of "large block" funds for two reasons, one illegitimate and one legitimate. Since the funds cannot as a matter of law functionally monitor industry, mutual fund managers have no reason to develop the requisite skills. Lacking those skills, fund managers would oppose allowing competition in a dimension in which most are unsuited. This is a standard kind of interest group pressure from incumbents. While real and probably determinative of the outcome, it is illegitimate.

A closely related consideration is, however, legitimate. Investors who see a risky "large block" fund fail may flee all mutual funds as vehicles for their savings. This flight would be unfortunate. Investor protection would demand heavy disclosure of the risks of concentrated blocks, so that unsophisticated individuals aren't bilked. Any deregulation should categorize "large block" funds as a vehicle quite different than the current mutual funds. That way, the inevitable failure of some "large block" funds will not spillover to the rest of the industry. Distinguishing the two types of funds, making the "large block" funds a separate industry, would require at a minimum that they have a catchy name that is clearly distinct

¹¹⁹ See 1940 Act § 18(a)(1), (f)(1), 15 U.S.C. § 80a-18(a)(1), (f)(1) (1988).

from mutual funds. Unfortunately, I do not have that catchy name yet.

We should keep in mind that within its purposes—diversification and professional management—the current rules work well. Any deregulation should leave the current industry alone, regulated as it is now. A parallel industry of collective investments could arise with a different set of regulations, similar to proposals for banking to allow an ultra-safe, federally-insured narrow bank while a connected, less-regulated, uninsured bank bore risks and undertook activities not now permitted banks.

Of greater weight in the deregulation balance is the risk that it would harm the very matter that interests us: oversight of managers. There's evidence that institutional ownership sometimes *enhances* managerial power.¹²⁰ As I've said, financial institutions want to sell their products. Insurance companies and banks want to sell loans, for example. Mutual fund complexes cannot sell loans, but they are not without anything to sell. They would like to manage pension plans. In the recent battle over anti-takeover legislation in Pennsylvania, some mutual funds opposed the legislation. Allegations were heard that one fund dropped its opposition to the anti-takeover bill when managers at a large Pennsylvania corporation switched administration of the company's pension plan to the mutual fund.¹²¹

If these risks seem large enough, deregulation could be coupled to a back-scratching prohibition: no 5%+ ownership if the fund, or an affiliated group, sells pension services to the 5%+ company. Furthermore, we may have a bump on a continuum. A sizable, but uninfluential block in the hands of someone with something to sell enhances managerial power. But at some point, the block becomes so large that power shifts to the institution, and it becomes relatively more interested in making money by making the company well-run rather than by selling a few dollars of services to the company.

Moreover, the shareholder of a mutual fund has more power to deal with conflicts of interest of *mutual fund* managers than she does to deal with conflicts of interest of *corporate* managers. To sever her ties with conflicted and underperforming corporate managers, the shareholder must overcome severe collective action problems. She

¹²⁰ See Brickley, Lease & Smith, *Ownership Structure and Voting on Antitakeover Amendments*, 20 J. FIN. ECON. 267 (1988).

¹²¹ See Crovitz, *Keystone State Kapitalism*, Barron's, Apr. 23, 1990, at 10, col. 1.

must mount a takeover or proxy contest to get rid of the offending managers. True, she can sell her shares to someone else. But that someone else is inextricably bound to the offending managers, unless *he* can overcome the collective actions problems. Since he will be bound, he will only pay her for the value of the package: a pro-rata interest in the underperforming firm afflicted with these managers. In contrast, the owner of the typical open-end fund may *redeem* her shares. She can send the shares into the company, and get her money back *from the company*. The offending managers could quickly find themselves with no assets to manage. Redemption is a serious risk for sub-par mutual fund managers.

Lifting fragmentation rules for nonconflicted mutual funds is the easy advice. The difficult questions arise from the rules that prohibit joint action with other financial institutions. Joint action is where the largest gains and the largest risks lie. Even today, the largest equity mutual fund has no more than \$15 billion in assets.¹²² (Groups of mutual funds have larger aggregate assets.) That's a lot on some absolute scale, but not so much that lots of industry monitoring can occur from a mutual fund acting alone. After all, most investors want diversification from mutual funds, even if the funds can provide monitoring services. Because of this investor demand for diversification, only some mutual fund assets will be switched into monitoring. Additional assets may flow *into* monitoring mutual funds from other savings vehicles, *if* funds can enhance returns by improving corporate governance. But it is the *largest* of the public corporations, the Fortune 200 companies, say, or those that cannot readily have a substitute monitor—a rich individual, or the takeover market for example—that are the firms most likely to benefit from enhanced monitoring. But these firms are the most difficult for even the largest mutual funds to monitor, since the funds cannot acquire a large enough block to have influence. A *group* of financial institutions might be needed. That is, savings can be found in mutual funds, banks, insurance companies, and pension funds. Each savings vehicle has a separate savings function; linking a few multi-billion dollar blocks together could enable financial institutions to enter the boardrooms of the largest industrial companies, as do financial institutions in other nations.

Compensating the mutual fund advisor is a problem. If the advisor monitors or enters the portfolio company's boardroom, it

¹²² See STANDARD & POOR'S/LIPPER, MUTUAL FUND PROFILES 103 (May 1991).

will incur expenses, which it would ordinarily pass onto the mutual fund shareholders. If these expenses are more than trivial, the mutual fund's shareholders have an inducement to withdraw from the fund and invest their money in parallel investments, free-riding on the mutual fund shareholders that remain and bear all of the expenses. It is rational for the mutual fund shareholders to withdraw *even if* the expenses produce greater gains in the value of the portfolio stock. Withdrawal would allow the stockholder to get the gains without incurring the expense.

But if the mutual fund could take big blocks and act easily with a block *owned* by an affiliated institution, then the affiliated institution might bear some of the expense (but only to the extent it benefits the institution's directly-owned block).¹²³ The mutual fund stock would be there just to give the affiliated institution enough voting power to get into the boardroom. But this relationship is exactly the kind that risks serious conflicts of interest; deductively it is unclear whether the gains outweigh the losses.

I can sketch a few of the general problems here. First, we just do not know how substantial the gains would be from institutional entry into the boardroom.¹²⁴ Without a rough estimate, it's hard to know how much risk we should run of conflicts of interest or of concentration of economic power. Second, as I said, the big governance gains are not going to come from unleashing mutual funds alone, but from *networking* of several institutions. But these linkages create the greatest risks of the very thing that fragmentation was designed to prevent: concentrations of economic power and conflicts of interest. The bank linked with the mutual fund, may take control not for enhancing industrial governance, but to make sure it can place high-priced loans with the portfolio company. Value is thereby transferred from the mutual fund and its shareholders to the bank and its shareholders.

Nevertheless, the balance between governance gains and concentration losses probably should be shifted a bit. What we cannot say is how much it should be shifted. Conflicts can be minimized by allowing networking only if the other institutions in the network also forsake selling their products to the portfolio company.

¹²³ See R. HARDIN, *COLLECTIVE ACTION* 76-78 (1982).

¹²⁴ For a brief discussion of the limits and costs of institutional monitoring, see Roe, *A Political Theory*, *supra* note 5, at 54-59.

The focal point for readjusting the balance between conflicts, concentrated power, and governance would be the prohibition on joint activity with nonconflicted affiliates. Possibly, some of these prohibitions could be partially lifted. That is, today the 1940 Act prohibits, absent SEC exemption, a mutual fund owning 5%+ of a portfolio company from acting jointly—to go onto the portfolio company's board, for example—with its investment advisor or any entity that owns 5%+ of the same portfolio company.¹²⁵ This prohibition could be diluted for affiliates that are insurance companies, other mutual funds, bank trust departments, and pension funds, as long as the other financial entities do not sell their products to the portfolio company.¹²⁶

Such rules would not be perfect. If the downside can be alleviated by reducing the prospect of conflicts of interest, then the question is how much upside there will be. For this I cannot be tremendously optimistic. True, mutual funds (and other institutional investors) seem recently to be more carefully attending to shareholder voting than they once were. This improvement in small-scale monitoring is a reason for optimism. But mutual funds could continue to be oriented to short-run price performance, because that is the way fund managers get ahead, or because fund managers must heed the short-run orientation of the individuals who buy shares of mutual funds. Even if law and politics helped induce the separation of Wall Street from Main Street, reversing law may not easily undo the separation. Corporate culture and history cannot be so easily reversed.

And the potential gains from monitoring cannot be enormous. A mutual fund *could* be organized that took only influential blocks. It would be taxed at rates of 6.8% and 10.2% on its dividends and 34% on its capital gains, when realized. It would be regulated as a 1940 Act company.¹²⁷ It would have to put up with other securi-

¹²⁵ See 1940 Act § 17(a), (d), 15 U.S.C. § 80a-17(a), (d) (1988); 17 C.F.R. § 270.17d-1 (1990); Kroll, *The "Portfolio Affiliate" Problem*, 3 ANN. INST. ON SEC. REG. 261 (R. Mundheim & A. Fleischer, Jr. eds. 1972); Rosenblat & Lybecker, *Some Thoughts on the Federal Securities Laws Regulating External Investment Management Arrangements and the ALI Federal Securities Code Project*, 124 U. PA. L. REV. 587, 651-54 (1976); Comment, *The Application of Section 17 of the Investment Company Act of 1940 to Portfolio Affiliates*, 120 U. PA. L. REV. 983 (1972).

¹²⁶ Rule 17a-6 exempts some joint efforts, but not the interesting ones. See 17 C.F.R. § 270.17a-6 (1990). Rule 17d-1 restricts most interesting joint efforts. If applicable in Germany, it would prohibit many of the alliances that empower bankers to enter the corporate boardrooms. See *id.* at § 270.17d-1.

¹²⁷ When a company has 40% of its assets in investment securities, it becomes a

ties regulations that kick in for large blockholders. If we estimate the average tax cost as 10% or 15%, and the "tax" from 1940 Act restrictions as another 5% or 10%, and the "tax" from other securities restrictions as another 5%, then total costs come to 25%, more or less. This cost is not impossible to overcome. Since we don't see such funds, we must believe that such funds could not improve corporate operations by more than 25%. Two alternatives could explain the modest potential gains. (1) Funds with control simply could do little good in any state of the world. The difference between the American securities-market-centered finance and other nations' financial-institution-centered finance is one of form and not of performance. Or, (2) substitute forms of monitoring—such as that from rich individuals, the takeover market, the capital market, and product market competition—reduce the advantages of outsider monitoring to 25% or less.

Whether such deregulation is *politically* possible is another question. Perhaps managers cannot succeed in defeating what seems to be public-regarding legislation. Perhaps mutual funds in the boardroom could not arouse public passions in the same way that takeovers can. The SEC's position could make a difference. If the SEC proposes to loosen up the constraints on mutual funds in the 1990s, as opposed to tightening them up as the SEC advocated in the 1930s, the political balance, and the perception of where the public interest lies, could tip in favor of allowing larger mutual fund blocks.

CONCLUSION

Just when Berle and Means were announcing the emergence of the public corporation with uncontrolled managers at the helm, Congress raised the cost or made impossible mutual fund influence of industry. The restrictions in the 1936 Tax Code and the 1940 Act make it impossible to deploy a majority of the fund's portfolio in influential blocks. The 1940 Act raises the cost of influence even with the unregulated portion of the portfolio by regulating or prohibiting activities with affiliates.

presumptive investment company. See 1940 Act § 3(a)(3), 15 U.S.C. § 80a-3(a)(3) (1988). If through *majority*-owned subsidiaries, the company were engaged *primarily* in its subsidiaries' business, then it gets an exemption from the 1940 Act. This is essentially saying that if the portfolio companies are subsidiaries, and the investment company is a holding company parent, the 1940 Act doesn't bite.

Elements of a "traditional" public choice story—of interest groups buying favorable legislation—are present. But surprisingly the interest group story does not drive the legislation. The ideology of fragmentation seems paramount. Key actors—FDR, Douglas, Brandeis, and Wilson—thought that Wall Street control of industry was bad. The interest group story, if there is one, comes from the appeals some of them made, favoring managers over bankers, and from the persistent survival of the fragmenting legislation. Congress simultaneously passed the fragmenting tax legislation and an undistributed profits tax, which threatened managerial independence. The threatening tax was unstable, challenged, and eventually repealed.

Rather than an interest group story, we should think of the politics of mutual funds in the 1930s as *creating* mutual funds. Without tax exemption, the funds could not survive. Politicians allowed tax exemption consistent with their conception of what a mutual fund should be and should not be. It should not control industry; it should not have concentrated investments; it should not be entangled in financial alliances that could create conflicts of interest. Politicians created a framework for mutual funds to grow, a framework that made it difficult or impossible for mutual funds to actively affect portfolio companies.

Undoubtedly investors want many things: diversification, low risk, high return, instant liquidity, easy evaluation of the investment, no risk of conflict of interests in any intermediary, and perfectly-managed industrial companies. Obviously, some goals must be traded off against others. The 1940 Act and subchapter M make it easy to diversify and get high liquidity. They minimize the conflicts of interest between the fund advisor and fund owners. But they don't easily allow investors to buy an intermediary that takes big stock positions and forms coalitions with other financial institutions to sit on the boards of portfolio companies. These laws reduce the agency costs in the intermediary, but are unhelpful in reducing the agency costs in the portfolio company, or in integrating industry with capital, by facilitating the flow of soft and proprietary information from the industrial company to capital intermediaries that take large stock positions and sit on the boards of portfolio companies. Perhaps that is the right trade-off to make. But it isn't obvious that it is the only plausible way to trade-off goals; it is not the trade-off made in other countries.

The fragmented ownership structure of the large public corporation is often thought to be a natural economic evolution.

Perhaps it is. But it is hard to be sure when politics raises the cost of, or prohibits, powerful financial institutions from entering the boardrooms of industry and, for better or worse, from influencing management of the largest companies. Financial institutions controlling large blocks of stock are rarely found in the boardrooms of the largest companies; the fragmentation of mutual funds is one reason why.

